Serving Two Masters

The Position of Internal Auditing between Different Stakeholders

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Abstract

Internal auditing is deemed to be a central supporter of internal and external stakeholders regarding fundamental questions in the area of risk management, internal control systems and the whole governance process. However, the existence of several stakeholders involves a high potential for conflicts within the auditing activity due to different requirements, interests, exertions of influence and reporting paths. This stress ratio between internal auditing and stakeholders can be comprised by the term "serving two masters". Besides the existence of different addresses there are several influence factors, which affect the arrangement of the serving two masters problem. These include processes, contents, persons and external influences. For instance, the practical problems can be exacerbated by the composition of the disciplinary and functional lead of the internal auditing, the reporting paths and the mission of assignment. Furthermore, personal and content-based components as well as external influences can cause or intensify the serving two masters conflict situation.

Also in one- and in the two-tier-system the significance of the serving two masters problem has increased. It particularly describes the connection between internal auditing, board of directors and audit committee or respectively the supervisory board. The growing importance of this topic is mainly supported by regulatory modifications e.g. in Europe. Involving this development internal auditing is no longer just subordinated to the board of directors, but gets more and more in the focus of the audit committee and the supervisory board.

Introduction

Since several years the term "Serving Two Masters" has a high relevance for the internal auditing activity in the English-speaking areas. In a monistic system a definitely conflict exists between internal auditing, the board of directors and the audit committee, which is normally staffed by external members. But also in the dualistic system, for example in Germany, is this circumstance omnipresent. Internal auditing as a "supporter" for the board of directors has also connections towards the audit committee or rather towards the whole supervisory board, which also can create a constellation with a relevant stress ratio. As the results of the global "Common Body of Knowledge"-survey, made from the Institute of Internal Auditors (IIA), proof, the activities of internal auditing are characterized through the interface towards the audit committee or supervisory board and towards other stakeholders. These interfaces can occur in different shapes, but the basic complex of problems is recognized consistently.

Especially since World War II the institutionalization of the auditing unit primarily aimed to take over control and monitoring arrangements regarding the order of the management. In this context Lawrence Sawyer characterizes at the beginning of the 1940s internal auditing in his handbook as "eyes and ears of management".

The auditing functions in this understanding only as a servant and a colleague for the board of directors by the required control of the business processes and gives if applicable recommendations towards the management. The recommendations given by internal auditing should be comparable to those recommendations made by the board of directors if the board would have conducted the audit themselves. Based on the plenty cited definition of the internal auditing through the IIA this approach has changed completely and expanded comprehensive:

"The internal auditing supplies independent and objective audit and consulting services which are aligned to add value and improve business processes. It supports the organization to reach their aims through a systematic and target-oriented approach to assess and to help to improve the effectiveness of the risk management, the control and the process of management and the process of monitoring." According to this the internal auditor acts not anymore as a servant of the board of directors, who cannot fulfill the necessary audits and controls in the company by themselves due to time restrictions, but serves rather more as a central supporter for different addressees for basic tasks of the risk management, the internal audits and the whole Governance-process. These various addresses or stakeholders are to be found in different levels in the company:

- **Board of directors**
- **Management** as further addressee of the audit and as a minor level management
- and **audit committee** or rather **supervisory board** as the highest supervisory unit

Additionally a multitude of further addressees can exist, for example the external auditor, regulators, supervisory authorities or shareholders. But without enlarging the network of the addresses the position between board of directors, management and supervisory board produces many potential conflicts regarding auditing activities already. These potential conflicts are caused on different demands, interests and positions of power of each addressee but also on different reporting paths in the company.

Often **the management of the tested unit** connects the function of the audit with efficiency and effectiveness improvement while the focus of the audit committee, the supervisory board and the board of directors is primarily on securing compliance of all business processes and all functional capability of the risk management and of the internal audit system through the internal auditing. But next to this different focus, overlapping interests and aims of each addressees like risk minimization in the tested unit or securing a functional internal auditing system do exist of course.

Especially through the EU-Greenbooks regarding the creation of a consistent Corporate Governance framework for Europe, the duties and the competencies of the board of directors and of the audit committee have changed.

While before the focus of the supervisory board or audit committee was to monitor the management through the board of the directors, the monitoring and the supervision of the audit function belongs now to the legal bounded activities. Hereby, the connection between supervisory boards and auditors obtains the first time to a legal anchor. While this goes not along with the disciplinary or functional connection from both units the auditing is now the concern of the supreme supervisory unit.

Increased liabilities‘ regulations require the constant improvement of existing governance system and risk system to minimize the liability risk. The demand of information for the board increases enormously, based on these challenges and requirements. For an appropriate supervision the supervisory board is in a need of the results and the reports of the internal auditing. Furthermore the board has an increased interest of a "punchy" auditing unit which can also guarantee the functional capability of the internal controls, the risk management and the compliance in their position in the Three-Lines-of-Defence-modell. Simplified for the supervisory board "a good auditing means a good corporate governance" and so a less liability risk. From the supervisory board's point it is more than desirable to apply the auditing in the above-named relevant positions and processes in the company. The interests of the supervisory board are through this almost the same as the board of the directors. Nevertheless the board of directors has still the disciplinary and functional sovereignty over the head of the auditing and the auditing, due to this fact the requirement and tasks of the supervisory board's auditing can only occur through the board of directors as "intermediary". Before the interaction from the board of directors, the supervisory board and the internal auditing is presented detailed following empiric results will show the strong connection of these three units in Germany